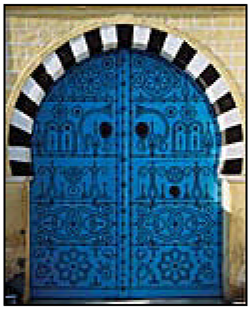

FINANCE and DEVELOPMENT
A quarterly magazine of the IMF

March 2003, Volume 40, Number 1

Unfulfilled Promise

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Why the Middle East and North Africa region has lagged in growth and globalization

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The Middle East and North Africa (MENA), a region of almost 500 million people, benefited immensely from the wealth created by the sharp increase in oil prices in the 1970s. The explosion of investment and growth in the oil-exporting countries was echoed in other parts of the region, with a sharp rise in worker remittances and increased trade and capital flows leading to a remarkable improvement in living standards. In addition, financial assets were accumulated abroad as overall national savings exceeded investment, especially in the oil-producing countries. But the boom period soon faded, prompting a slowdown and, in many cases, a decline in growth rates in the 1980s, as oil prices and production softened, leaving the governments, which had grown considerably in size in the previous decade, burdened with deficits and debt.

Despite attempts to spur recovery and initiate structural reforms, many countries in the region remain on a slow growth path, effectively sidelined from globalization and the benefits of closer economic integration with the rest of the world. Although the region still dominates the global oil market, the benefits from oil that had brought about a marked improvement in living conditions in the 1970s and early 1980s failed to generate a sustained growth dynamic or bring about greater regional economic integration. In part because of resource endowments, but also because of historical factors, income levels continue to vary widely. Per capita GDP in 2001 ranged from an estimated high of $27,900 for Qatar to $350 for Mauritania. What went wrong?

This issue of *Finance & Development* takes a look at some of the root causes of the comparatively slow growth of the past two decades, the problems this has caused, and some possible solutions.

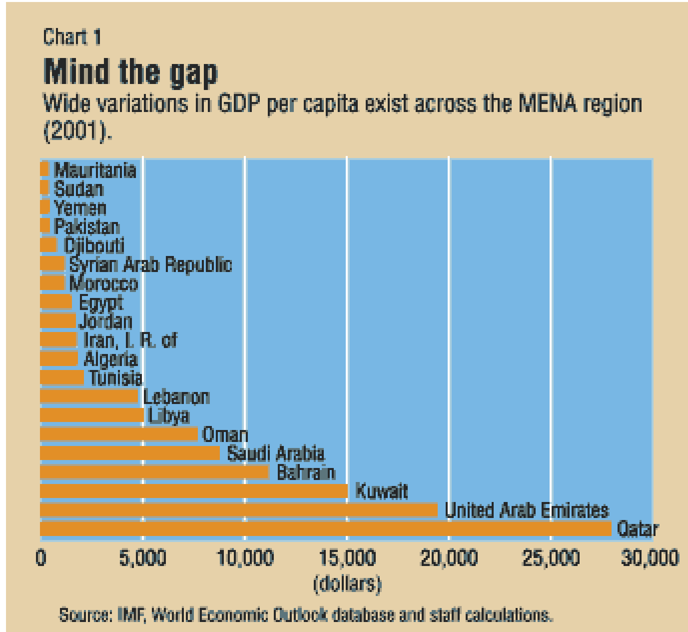
What countries are in MENA?

The Middle East and North Africa (MENA) region discussed in the following five articles comprises the Arab states in the Middle East and North Africa—Algeria, Bahrain, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, the Syrian Arab Republic, Tunisia, the United Arab Emirates, and Yemen—plus the Islamic State of Afghanistan, the Islamic Republic of Iran, Pakistan, and the West Bank and Gaza.

These 24 countries and territories, comprising about 7.5 percent of the world's population, are grouped together for analytical purposes only. They share common challenges and cultural links distinct from neighboring economies, including those of Israel and Turkey. The region's GDP is approximately $807 billion (at current exchange rates) or 2.6 percent of world GDP. The dominant religion is Islam, although there are sizable religious minority groups (particularly Christian) in several countries, including Egypt and Lebanon. Arabic is the principal language spoken throughout the region, except in Afghanistan, Iran, and Pakistan. French is spoken along with Arabic in the Maghreb countries of Algeria, Mauritania, Morocco, and Tunisia. The six countries on the Persian Gulf—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates—formed the Cooperation Council of the Arab States of the Gulf (GCC) in the early 1980s and plan to establish a monetary union with a single currency by January 1, 2010.

Common heritage

Even though there is a wide gap between the richest and the poorest countries in the region (Chart 1), most of the MENA countries (see box) share a common cultural and institutional heritage, along with common economic and social challenges—among them relatively high rates of growth of population and labor force, slow economic growth, and weak links to the global economy.

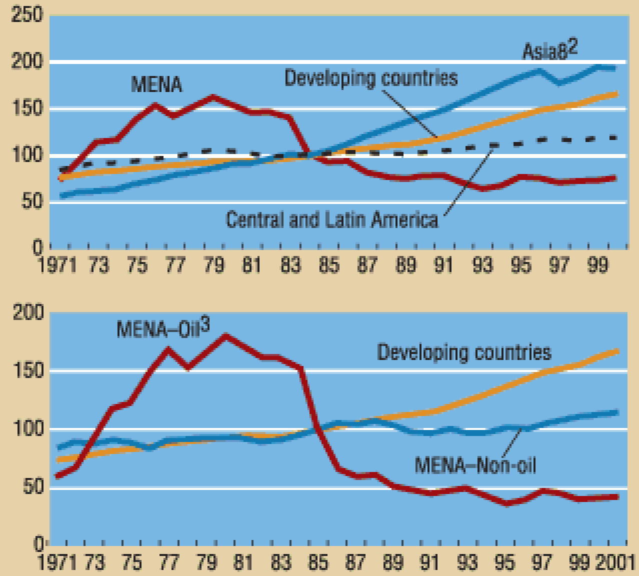


Indeed, real per capita GDP growth in the MENA region over the past two decades has faltered compared with the rest of the developing world (Chart 2). Although the non-oil economies in the region performed better on average than the oil economies, their per capita GDP growth rates are still below the developing country average. The non-oil sectors of the oil economies have been growing steadily at 2.5 percent to 4.0 percent a year, but the per capita growth rates in these countries have been brought down by slowing oil production and rapid population growth. Even taking account of the boom period of the 1970s, real GDP growth for the MENA region averaged 3.5 percent over the past three decades, well below the 5 percent average for all developing countries. At the same time, population growth rates in the MENA region (averaging 2.7 percent in 2001) are above those in other regions (1.5 percent on average for low- and middle-income countries in 2001). Rapid labor force growth has outpaced growth in employment. Thus, although other human development indicators in the region have improved, significant challenges remain.

Chart 2

Declining fortunes

In terms of real GDP per capita, MENA has lost ground compared with other developing countries.[1]



Source: IMF, World Economic Outlook database and staff calculations.

[1]GDP weights in purchasing power parity terms are used for all aggregates except Asia8, which is a simple average.

[2]Asia8: Hong Kong S.A.R., Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan Province of China, and Thailand.

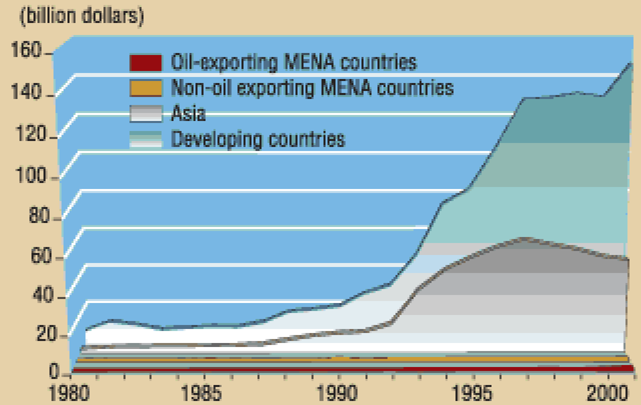
[3]MENA–Oil countries are Algeria, Bahrain, the Islamic Republic of Iran, Kuwait, Libya, Oman, Qatar, Saudi Arabia, the United Arab Emirates, Sudan, and Yemen.

Moreover, MENA countries are poorly integrated with the world economy. The region receives only one-third the foreign direct investment expected for a developing country of an equivalent size (and most is concentrated in enclave sectors of a handful of countries (Chart 3)), while portfolio investment is virtually nonexistent because equity markets are under-developed. Global financial integration lags behind that for other developing countries; less than half of MENA countries have meaningful access to financial markets. Trade performance is below that of other regions: while oil exports continue to be a substantial source of foreign exchange earnings for oil producers, the relative importance of such exports has declined since 1985 (Chart 4). The growth of non-oil exports varied during this period but, on the whole, was slower than for developing countries as a group. As a result, the MENA region's share of the world export market fell by more than half between 1980 and 2000 (the results are the same including or excluding oil exports), whereas the developing countries' share rose slightly during this same period. The region's information and technology links are among the weakest in the world—the number of Internet users per capita, for example, is low compared with other regions (Chart 5).

Chart 3

No magnet

MENA has failed to attract sufficient net foreign direct investment compared with its economic size.

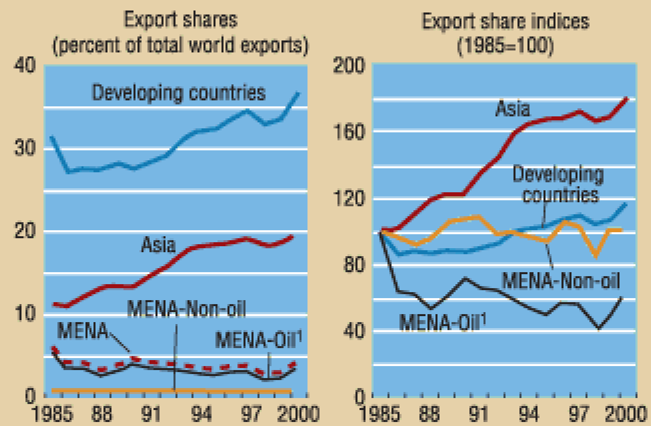


Source: IMF, *World Economic Outlook, October 2002* (Washington).

Chart 4

On the sidelines

MENA's share of world exports fell by more than half between 1980 and 2000.



Sources: IMF, *Direction of Trade Statistics*, Information Notice System, and staff calculations.

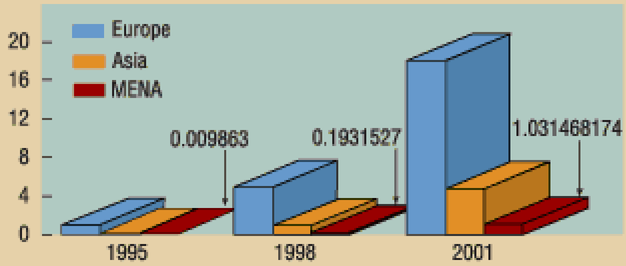
[1] MENA–Oil countries are Algeria, Bahrain, Iran, Kuwait, Libya, Oman, Qatar, Saudi Arabia, the United Arab Emirates, Sudan, and Yemen.

Chart 5

Waiting for a connection

The number of Internet users has risen slowly compared with Europe or Asia.

(percent of total population)



Source: International Telecommunication Union, 2002, *World Telecommunication Development Report* (Geneva, Switzerland).

Common problems

What is the root cause of this economic malaise? The slowdown in economic reforms is no doubt a key factor. Granted, many MENA countries moved ahead with macroeconomic and structural reforms during the late 1980s and early 1990s. These included such areas as fiscal reforms (implementation of the value-added tax in several countries, phasing out of subsidies, and expenditure-management reform), introduction of indirect monetary policy instruments, liberalization of the trade and foreign direct investment environment, and introduction of some flexibility in exchange rates. Those countries that did pursue reforms (such as Egypt, Jordan, Mauritania, Morocco, and Tunisia) enjoyed the region's most rapid growth rates over the past two decades. However, the early optimism about the depth of the reform commitment of governments in the region has waned, and the expected impact on economic growth has not been fully realized. One reason may be that the reforms did not achieve a necessary critical mass or did not go deep enough to address long-standing structural rigidities and distortions. Research argues that policy complementarity is important: growth requires a moderate degree of success in several policy areas simultaneously, because poor performance in one area can thwart broad-based progress.

Another key factor is the region's inability to take advantage of increasing globalization. Although globalization has its risks, research shows that countries that undertake policy and institutional reforms in such areas as trade, the financial sector, and governance are better equipped to benefit from increased international trade and capital flows and are therefore likely to experience higher gains in per capita income.

Overall, the problems holding back the region may be attributed to five key factors:

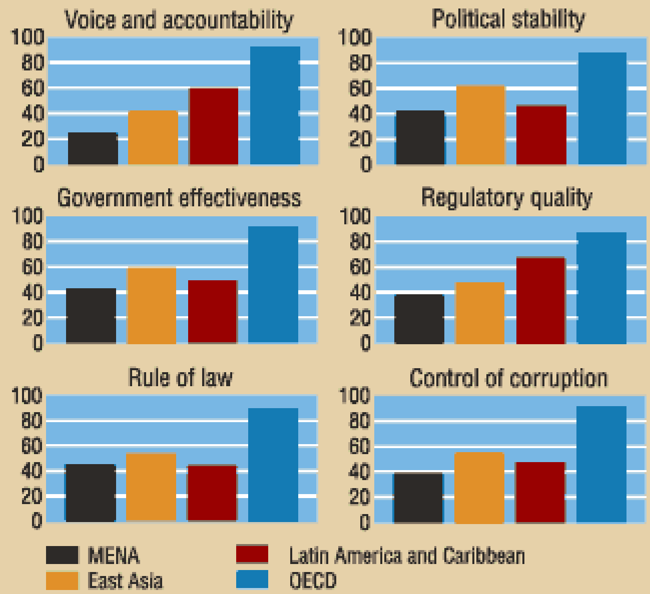
Lagging political reforms. Partly because of the region's geopolitical importance, external hegemonic influences prevail over weak state systems governed largely by authoritarian regimes. Political fragmentation and recurring conflict have hampered the development of democratic institutions and remain a major obstacle to economic reform. As noted by the recent *Arab Human Development Report*, published by the United Nations Development Program, the region performs poorly when it comes to civil and political freedoms, gender equality, and, more generally, opportunities for the full development of human capabilities and knowledge. The modern institutions needed to overcome these handicaps—such as freely elected legislatures, competent and independent judiciaries, and institutions that safeguard civil and human rights—are weak and poorly developed. The demarcation lines between the public and the private sectors are often unclear, encouraging conflict of interest, rent seeking, and widespread corruption. While there are exceptions, transparency in government is poor and accountability is rare (Chart 6). Civil society organizations, such as professional associations, free and independent media, and autonomous nongovernmental entities, are weak and are often co-opted by governments. As a consequence, citizen participation and private sector initiative have remained constrained.

Chart 6

Voice of the people

With some exceptions, government accountability remains low, and other governance indicators lag, in the MENA region.

(percent)[1]



Source: Daniel Kaufmann, Aart Kraay, and Pablo Zoida-Lobaton, 2002, "Governance Matters II: Updated Indicators for 2000/01," World Bank Discussion Paper 2772 (Washington).

[1]Each entry indicates percent of countries worldwide that rate below selected country or region for each governance indicator. Higher score for any indicator shows better governance outcome. Aggregates are simple averages.

Dominant public sectors. Despite some progress with privatization, most economies are still dominated by inflated state institutions and large public enterprise sectors. In the face of rising unemployment, the public sector has increasingly served as the employer of last resort, inflating public payrolls and wage bills. Governments in the region are relatively large and have been, for the last generation, net dissavers. Some countries have pursued fiscal reforms, such as tax reforms, and improved transparency and expenditure control. And some progress on privatization, particularly in the region's telecommunications sector, is evident. However, by international standards, the MENA countries continue to lag in the development of an economic and financial environment conducive to entrepreneurship, risk taking, and private sector–led investment and growth.

Underdeveloped financial markets. Financial sector development, which advanced in the 1970s through the mid-1980s, when the region was ahead of the newly industrialized economies, has slowed in recent years, and MENA now lags behind these countries. Among noteworthy reforms—undertaken by most of the GCC members and a few other countries (such as Jordan, Lebanon, Morocco, Sudan, and

Tunisia)—were those that strengthened financial sector regulation. Some countries have introduced indirect monetary policy instruments and others (such as Afghanistan, Iran, Pakistan, and Sudan) have undertaken exchange rate reforms. However, despite these efforts, financial markets in the MENA region remain shallow and fragmented. Banks are dominated by public ownership or control and have considerable exposure to government debt; regulations are outdated; management is poor; and links to international capital markets are weak. As a result, financial sectors in the region have not played the intermediation role needed to underpin investment and growth.

High trade restrictiveness. Research indicates that trade openness—defined as the degree to which foreigners and nationals may transact without government-imposed costs (from tariffs and nontariff barriers, for example)—contributes significantly to higher productivity and per capita income growth. Increased trade boosts productivity by importing knowledge and innovation. In the MENA region, trade regimes vary. Many MENA countries, including the GCC countries, Mauritania, and Yemen and, to a lesser extent and more recently, Algeria and Jordan, have liberalized their trade regimes. However, the remaining countries, despite trade liberalization efforts (such as recent changes in Iran, Morocco, Pakistan, and Sudan), continue to maintain relatively high tariffs and nontariff barriers. As a result, for the MENA region as a whole, overall trade restrictiveness (as measured by an index developed by IMF staff) is double the developing country average.

Inappropriate exchange rate regimes. Many countries in the region maintain inflexible exchange rate regimes, including pegs or narrow bands. While pegging can sometimes be useful, countries have tended to delay adjustment in the presence of real exchange rate appreciation or have shown reluctance to exit an inflexible arrangement when this is called for. Inappropriate exchange rate regimes are thought to be a major factor in the slow growth of non-oil exports. They may also have delayed the development of monetary policy frameworks (such as inflation targeting) that are judged to be more suitable to emerging economies in the region—such as Jordan, Lebanon, Morocco, and Tunisia—seeking to integrate more fully with the world economy.

Looking ahead

How can the MENA region get back on a high growth path and better integrate with the global economy? The past two decades have seen a clear movement toward macroeconomic-related structural reforms; however, these did not go far enough to address deep-rooted structural and governance issues. While the discussion above makes clear the complexity of the reform effort, the region cannot afford to stay on the sidelines because of a lack of progress in critical areas. Building on the example of the region's early reformers, accelerated and broad action on structural reforms is needed, including a fundamental reassessment of the role of the state in the economy; the creation of a rules-based regulatory environment with appropriate incentives for private sector initiative; faster trade liberalization; financial market reform; and improved transparency, governance, and quality of state institutions. Economic liberalization should seek to ensure fair and open competition where market forces could create opportunities for a more efficient allocation of resources and support strong investment and growth. Finally, linguistic and cultural homogeneity, coupled with vast differences in endowments and levels of development, should constitute a compelling case for extracting enormous benefits from greater regional economic integration.

Each of the articles that follow looks at a piece of the puzzle—from the overarching need to escape the ghosts of central planning and create jobs to the pivotal requirement for more developed financial sectors supported by appropriate exchange rates.

Further reading:

George T. Abed and Sanjeev Gupta (eds.), 2002, Governance, Corruption, and Economic Performance *(Washington: International Monetary Fund).*

Patricia Alonso-Gamo, Annalisa Fedelino, and Sebastian Paris Horvitz, 1997, "Globalization and Growth Prospects in Arab Countries," IMF Working Paper 97/125 (Washington).

Nicholas Crafts, 2000, "Globalization and Growth in the Twentieth Century," IMF Working Paper 00/44 (Washington).

Dipak Dasgupta, Jennifer Keller, and T.G. Srinivasan, 2002, "Reform and Elusive Growth in the Middle East—What Has Happened in the 1990s?" World Bank Working Paper 25136 (Washington).

United Nations Development Program, 2002, Arab Human Development Report *(New York).*

World Economic Forum, 2002, Arab World Competitiveness Report *(New York: Oxford University Press).*

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